

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of }
EASTERN-COLUMBIA, INC. }

Appearances :

For Appellant : Sheldon Richman and
George A. Sims
Certified Public Accountants

For Respondent : Lawrence **Counts**
Associate Tax Counsel

O P I N I O N

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the Protests of Eastern-Columbia, Inc., against proposed assessments of additional franchise tax in **the** amounts **of** \$1,598.38 and \$3,010.31 for the income years ended February 28, 1958, and 1959, respectively.

The sole question raised by this appeal is whether certain expenditures made by appellant during the income years on appeal were properly deducted as expenses, or whether those amounts represented depreciable capital expenditures.

Appellant, a California corporation created in 1903, is the owner of numerous parcels of real estate. One of its holdings is a twelve-story building constructed in 1930 in downtown Los Angeles, California. Until 1957 that building housed a well-known department store operated by appellant. The top four floors of that building have been leased out to a tenant since 1955.

In May 1957 appellant terminated its operation of the department store, disposed of its merchandise, and began

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converting the building into an office building. In this Connection appellant installed central air conditioning, automatic elevators and new electrical wiring, created individual offices on most floors, and remodeled the lobby of the building. When a tenant for some portion of the building was located, appellant would make additional changes necessary to adapt the building facilities to the specific requirements of that tenant. The conversion program was substantially completed by February 28, 1959:

As each phase of the work was completed, the contractors submitted their itemized billings to appellant. At the end of each income year appellant's accountants analyzed the itemized statements. They treated disbursements for such items as repainting, patching, cleanup, demolition and removal of debris as deductible expenses, and capitalized the remaining expenditures. The resulting totals reported for-tax purposes were as follows:

<u>Income Year</u> <u>Ended</u>	<u>Capital</u> <u>Expenditures</u>	<u>Deductible</u> <u>Expenses</u>
February 28, 1958	\$ 179,605.00	\$ 41,516.36
February 28, 1959	501,205.17	74,162.40

During the income year ended February 28, 1959, additional amounts were expended by appellant for construction of a stairway, as required by the Industrial Accident Commission, on a separate piece of property which appellant owned in Huntington Park, California. Of the total cost of the project, \$11,312.26, appellant treated \$6,289.73 as a capital expenditure and the remainder, \$5,022.53, as deductible expense. The items expensed represented the cost of alterations in exit plumbing, wiring, etc., necessitated by addition of the stairway. Also deducted for the income year ended February 28, 1959, was an item of \$312.21 designated as the cost of "repairs necessary for tenant" in another separate building which appellant owned on Hill Street in Los Angeles.

Respondent determined that \$41,412.84 of the expenditures deducted by appellant for the income year ended February 28, 1958, and \$78,624.61 of the expenditures deducted for the income year ended February 28, 1959, constituted capital expenditures and were, therefore, not deductible.

Appellant protested the proposed additional assessments which resulted from respondent's disallowance of the expense deductions claimed, and respondent's denial of those protests gave rise to this appeal.

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Section 24343 of the Revenue and Taxation Code allows the deduction of "all the ordinary and necessary expenses paid or incurred during the income year in carrying on any trade or business." Federal counterparts of this section have been interpreted to allow the deduction of the cost of repairs necessary to maintain business property in an ordinary operating condition. (Joseph Merrick Jones, 24 T.C. 563, aff'd, 242 F.2d 616; Illinois Merchants Trust Co., Exec'r., 4 B.T.A. 103.) Section 24422 of the Revenue and Taxation Code prohibits the deduction of expenditures which are capital in nature rather than expense items.

Expenditures which might otherwise be deductible as ordinary and necessary repair expenses are not deductible where such expenditures are made in connection with a general plan of renovation, remodeling, or permanent improvement of the property (Joseph Merrick Jones, supra; California Casket Co., 19 T.C. 32; I. M. Cowell, 18 B.T.A. 997), or to adapt the property to a new or different use (Bee Holding Co., T.C. Memo Dkt. Nos. 62191, 71001, Nov. 24, 1958; Popular Dry Goods Co., 6 B.T.A. 78). In the Cowell case this distinction was expressed as follows:

... To fix a door or patch plaster might very well be treated as an expense when it is an incidental minor item arising in the use of the property in carrying on business, and yet, as here, be properly capitalized when involved in a greater plan of rehabilitation, enlargement and improvement of the entire property. (18 B.T.A. 997, 1002.)

Appellant contends that there never was any integral plan to make the former department store building into an office building, since the conversion took place over a long period of time, as tenants were located. In support of its argument that the expenditures were properly deducted as ordinary and necessary business expenses appellant also relies on the fact that many alterations to the building were done at the request of tenants, in order to adapt the facilities to their specific needs, and new adaptations would therefore have to be made as those tenants' leases expired and new tenants moved in. In addition, appellant protests respondent's disallowance of those claimed expense deductions which relate to other pieces of property owned by appellant.

After careful review of the record in the instant case we conclude that the disallowed expenditures on the former department store building were incidental to an overall plan to convert the building into an office building. Such a change in use undoubtedly required substantial structural alteration. It is true that the work extended over a number of months

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because of the time it took to find tenants and to adapt the facilities to their specific businesses. Nevertheless the expenditures which appellant has characterized as repair expenses were all made pursuant to a general plan to change the use of the building;

The capitalization of expenditures which otherwise might be repair expenses has been sustained where they were incurred in connection with an overall plan of improvement, even though the changes were made to comply with the specific requests or needs of a particular tenant. (Bee Holding Co., supra, T.C. Memo., Dkt. Nos. 62191, 71001, Nov. 24, 1958; Blanche Burbank, 3 B.T.A. 1118.) Respondent therefore properly disallowed the deduction of those expense items incurred in process of converting the building in downtown Los Angeles into an office building.

Appellant's expenditures on its properties in Huntington Park and on Hill Street during the income year ending February 28, 1959, were not incurred in connection with the above remodeling plan. Notwithstanding this fact, we believe that deduction of those amounts was properly disallowed by respondent.

The required stairway constructed by appellant on its Huntington Park property constituted a permanent improvement to the property, the cost of which must be capitalized and depreciated. The amounts charged to expense and deducted by appellant, totalling \$5,022.53, were expenditures necessitated by installation of the new stairway and therefore represent part of its cost. Those expenditures were not deductible as ordinary and necessary repair expenses.

The last item disallowed by respondent was incurred in connection with work on appellant's Hill Street building and was designated by appellant as "repairs necessary for tenant." Appellant has failed to give us any information as to the nature of those alleged repairs. Under those circumstances we cannot reverse respondent's disallowance of that amount as a proper expense deduction.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

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IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code that the action of the Franchise Tax Board on the protests of Eastern-Columbia, Inc., against proposed assessments of additional franchise tax in the amounts of \$1,598.38 and \$3,010.31 for the income years ended February 28, 1958, and 1959, respectively and the same is hereby sustained.

Done at Sacramento, California, this 7th day of February, 1967, by the State Board of Equalization.

Percy R. Leake, Chairm
John W. Lynch, Member
Donna K. [unclear], Member
_____, Member
_____, Member

ATTEST:

[Signature], Secretary